Comments on Proposed IRS Regulation REG-146097-09 Regarding
Reporting Interest Paid to Nonresident Alien Individuals

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My name is Stephen J. Entin. I am President and Executive Director of the Institute for Research on the Economics of Taxation. Before joining IRET, I served as Deputy Assistant Secretary for Economic Policy, Department of the Treasury, from 1981 to 1988. From 1975 to 1981, I was a staff economist with the Joint Economic Committee of the Congress. My areas of specialization include macroeconomics, international economics, and taxation. I am speaking today in my personal capacity as someone interested in tax policies that permit strong economic growth and a more prosperous world.

I offer comments on proposed IRS REG-14609-09, to impose reporting requirements for interest on deposits maintained at U.S. offices of certain financial institutions and paid to nonresident alien individuals. Because the bank interest and government bond income is tax exempt in the United States if the recipient is a nonresident alien, there is currently no requirement that the payer or the recipient report the interest to the IRS (except for interest paid to residents of Canada that is reportable pursuant to an information exchange agreement). The current system was deliberately enacted by the Congress to allow U.S. financial institutions to compete for business with offshore banks.

I testified at an IRS hearing on an earlier version of this regulation on November 12, 2002. At that time, I discussed the potentially adverse effect of the regulation on the U.S. economy. The regulation would scare investment capital away from the United States, impairing our ability to finance government budget deficits without crowding out private investment in job-creating capital. Non-resident individuals were reported to hold perhaps $1 trillion in U.S. financial instruments, and only a portion of that might be considered at risk for capital flight if financial privacy were threatened. We will not know for certain what the impact is until the event. However, as an illustrative example, I estimated that a reduced net capital inflow of perhaps $200 billion could lead to higher interest rates and less growth of the domestic economy, shading as much a 0.8 percent from annual output and income. That would be the equivalent to the income generated by about a million full time jobs in today's economy Fewer jobs and a lower GDP would result in lower federal and state and local tax revenue.

Since that time, the amount of foreign capital invested in the United States has only gotten larger, and there is potentially more capital that could flee the country. Federal deficits have gotten much larger, and more of the resulting debt is held by foreigners. I conclude that, if anything, the arguments against the regulation are even stronger today than nine years ago.

Much of the foreign-held U.S. debt is owned by governments and central banks. Recent figures indicate that China, the largest foreign holder of U.S. debt, has scaled back its holdings, while others continue to add to them. We cannot take such official purchases for granted indefinitely. This is not the time to antagonize individual foreign investors in the United States. For-

eign individual investors still have the capability of shifting deposits from the United States to friendlier banking centers with the click of a mouse. Even a small outflow could trigger a wider run on the dollar, necessitating Federal Reserve intervention to stem the tide.

The regulation is not needed to enforce U.S. tax law. Banks are already required to know the identities of their depositors under various know-your-customer, anti-money laundering, Bank Secrecy Act compliance and USA PATRIOT Act regulations, and the new FATCA regulations are likely to make it even harder for U.S. residents to hide their identities from the IRS. There is little reason to think that there is any significant amount of lost tax revenue associated with Americans pretending to be foreigners. Rather, the blanket information on non-resident aliens is being sought to assist foreign tax agencies to track down their citizens holding accounts in the United States. If the regulation were imposed, and the accounts were to flee to other jurisdictions, the IRS would have no useful information to report to other high tax nations. However, U.S. financial institutions and their employees would have lower U.S. profits and wages to report to the IRS, as would U.S. other businesses and employees deprived of funds to expand investment and hiring. In effect, a portion of our financial services industry offering secure and private banking facilities to people from politically unsettled parts of the world would be shut down, and the nation would be deprived of the use of the saving.

The United States already has information sharing agreements with a number of other nations in individual cases of suspected tax evasion. Many persons and institutions engaging in tax evasion or its accommodation have been apprehended using the existing tools. The discovery of these often highly sophisticated efforts at evasion by existing means suggests that these tools are sufficient; it is not evidence that more sweeping tools are needed. A more sweeping regulatory burden requiring the annual reporting on all accounts held by foreigners in U.S. financial institutions is not called for, and would be costly for the U.S. financial services industry.

The proposed regulation may be good for foreign governments, but would not be good for the U.S. economy. There would be no gain for U.S. tax enforcement. Weaker investment in the United States would reduce U.S. jobs and tax revenue beyond any possible reduction of tax evasion affecting money owed to the United States. The regulation also flies in the face of Congressional intent to exempt the earnings of such deposits from tax to attract the funds to the United States. My conclusion is that the proposed regulation would be harmful to the economy of the United States. It would provide no benefit to the U.S. Treasury, either in terms of administrative advantages or additional revenue. As such, it should not be adopted.

The real solution to the international information exchange issue is fundamental tax reform, here and abroad. Many of the proposals for fundamental tax reform in the economic literature would replace the income tax with consumption-based or consumed-income taxes. In these systems, interest income would receive the same tax treatment currently accorded regular IRAs and pensions, or Roth IRAs and tax exempt bonds. The tax systems also would be territorial rather than global in reach. Income earned outside the United States by U.S. residents would be attributable to already-taxed principal, and would not be taxable here. Nor would there be any U.S. tax on interest earned in the United States by foreigners. Neither the IRS nor the foreign tax agencies would need the information exchange program that is driving the proposed regulation. I might note that the largest holder of U.S. government debt, China, has something very close to

such a saving-friendly tax system. China's provincial income taxes do not tax bank interest, nor capital gains on stock traded on Chinese exchanges. While its system is global for individuals, the tax preference for domestic savings would act to minimize interest income from abroad. The national government of China does have an income tax, it uses a VAT, under which financial flows are not taxable. The high saving rate in China has fostered tremendous economic growth.

I recall a give and take between Treasury Secretary Don Regan and a Member of Congress at a House committee hearing in 1981 discussing the Administration's proposed budget and tax reductions to encourage investment in the United States. The Congressman berated the Secretary for assuming that the United States would benefit from additional investment by foreign lenders. Why should a developed nation receive capital from a less developed nation? Shouldn't we be sending our capital to them? Secretary Regan, fresh from his private sector career as head of Merrill Lynch, said that it was not his job as Secretary of the Treasury to go down to the beach and hold out his hand like King Canute and cry "halt" to foreign capital trying to enter the United States. We have at least as much need for foreign capital today as we did then.

Tax reform is, of course, beyond the scope of the IRS. Nonetheless, it would be good if the Service did not interfere with movement toward a more rational pro-growth tax system by propping up the current flawed international tax arrangements without Congressional approval.

It is common for people serving in a government agency in the United States to deal with the same issues, and share many of the same concerns, as their foreign counterparts. There is a strong tendency to want to accommodate each other's requirements and share in common solutions. But the interests of the United States and its workers and savers do not necessarily coincide with those of the governing officials of high-tax foreign countries seeking to prop up punitive anti-growth tax structures. We need to keep the focus on what is good for job creation and living standards in the United States.

The IRS is clearly primarily concerned with collecting taxes that are due, and it must enforce the tax law taxpayer by taxpayer. But it is part of the Treasury Department, which has other concerns as well, such as with bank soundness, economic growth, employment, and, yes, the tax revenues associated with a strong economy. Any regulation that could lead to banking problems, at least in specific areas of the country, should be weighed against that cost. A regulation that might affect the economy adversely should take some account of the wider concerns relating to total revenues and the federal budget, and opinions might usefully be sought from other parts of the Treasury, the Administration, and, where necessary, the Congress. The ultimate judge is, of course, the public at large. That is why we are grateful for the ability to speak and submit comments at hearings such as this. Thank you for your time and attention.

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